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Carrots and Sticks: By Auditing Executive Compensation and Benefits, Auditors Can Help Their Organization Move from Risk to Rewards Management

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Carrots and Sticks

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By auditing executive compensation and benefits, auditors can help their organization move from risk to rewards management.

BY SRIDHAR RAMAMOORTI AND
USHA R. BALAKRISHNAN

ALTHOUGH THE FOCUS OF RISK MANAGEMENT traditionally has been on downside risk, the time is right to focus this dialogue on upside risk — the management of value-creation opportunities through “rewards management.” After all, rewards such as bonuses and stock options are typically greater for those who identify and leverage new value-creation opportunities. For-profit organizations favor those individuals who are well-connected and leverage their relationships to bring in clients and attract customers. Their selling ability, revenue-generating strategies, and overall *modus operandi* quickly earn them the coveted title of “rainmakers.”

Nevertheless, rewards and incentives can encourage undesirable behaviors. Executives quickly learn that managing their organization’s accounts is far easier than managing the organization itself; indeed, it is sometimes harder to make the numbers than to “make up” the numbers. This is a behavioral risk that can only be managed through human intervention and oversight; technology cannot ensure everyone complies with regulations or company policies, or that no one has unfairly benefitted from undisclosed conflicts of interest.

A recent IIA Practice Guide, *Auditing Executive Compensation and Benefits*, emphasizes that strong governance systems are needed for executive compensation and benefits (ECB) programs. This is because executives often are in the position of both designing and recommending their own compensation, which creates a conflict of interest. Thus, internal auditors should consider specific risks regarding the employment market, compliance, financial reporting, reputation, operations, and external business relationships.

ECB design and rewards management pose a key risk for organizations. To date,

the conversation about risk management primarily has been about adopting the “sticks” approach with little attention paid to the “carrots.” A balanced risk management strategy should adopt a “carrots-and-sticks” approach in which the carrots encourage desirable behaviors and the sticks discourage undesirable behaviors. Tremendous opportunities exist for auditors to examine and help manage such sources of risk.

WHY REWARDS MANAGEMENT MATTERS

Most organizations realize that the key to attracting, developing, and retaining talent is a comprehensive and progressive compensation program that reinforces the organization’s stated outlook and the importance of its people. From a governance standpoint, publicly listed companies typically have a compensation committee to approve executive compensation packages. Compensation consultants frequently advise them in structuring these packages, but conflicts of interest among consultants, such as providing other services to the same company, are widespread, according to the Report on Executive Pay: Conflicts of Interest Among Compensation Consultants, a December 2007 study by the U.S. House Committee on Oversight and Government Reform.

Clearly, performance measurement and incentive compensation drives behavior. When the compensation scheme is poorly designed (i.e., it encourages reckless risk-taking), one might expect counterproductive, and even “gaming,” behavior by executives to meet predefined targets and performance metrics. Thus, when stock options are purely a function of stock price, executives may worry more about increasing the stock

price than achieving the organization's goals and objectives.

Recent stock-option "backdating" scandals are a reminder that when left unchecked, management and boards may not simply be indifferent about such compensation-gaming behavior — they may actively participate in it. A 2005 research paper by University of Iowa finance professor Erik Lie drew attention to the somewhat sinister practice of granting an employee stock option that is retroactively dated to increase its value. Lie examined options that weren't granted on the same date each year and discovered a pattern in which prices fell before the grant date and rose afterward. Neither external auditors nor internal auditors identified this "rewards management risk," possibly because stock options-based compensation was not recognized in the financial statements until 2004.

A CHANGING REGULATORY LANDSCAPE

Outsized CEO compensation has garnered attention in recent years. Former U.S. Public Company Accounting Oversight Board Chairman William McDonough

characterized the practice of providing lavish compensation to CEOs whose performance was questionable or below average as being "grotesquely immoral."

The U.S. Securities and Exchange Commission's new Compensation Discussion and Analysis (CDA) disclosure regime is designed to assist stockholders in determining whether a company's compensation programs incentivize employees to take excessive or inappropriate risks. Similarly, the federal government bailout of companies devastated by the financial crisis of 2008 led to the appointment of Kenneth Feinberg as the Obama administration's "compensation czar." His primary responsibility was to significantly limit the compensation of senior executives of companies that had become majority-owned by the U.S. government as well as for all recipients of funding from the Troubled Asset Relief Program.

The "risk from rewards management" figures prominently in the recently enacted U.S. Dodd-Frank Wall Street Reform and Consumer Protection Act. Among its governance provisions related to executive compensation, the Dodd-Frank Act:

- Gives shareholders a periodic advisory vote ("say on pay") on executive compensation and "golden parachutes."
- Prohibits brokers from discretionary voting in director elections and on executive compensation matters.
- Requires compensation committees to enhance independence criteria and requirements for independent consultants and advisers.
- Imposes requirements for claw-back policies for erroneously awarded compensation. Currently, 71 of the 100 largest U.S. publicly listed companies have implemented a claw-back policy.
- Imposes enhanced disclosures for compensation, company policies concerning employee and director hedging transactions, and company decisions regarding separation of the CEO and board chairman roles.

Clearly, internal auditing will play a significant role in ensuring compliance with the provisions of the Dodd-Frank Act. However, owing to the sensitive nature of auditing executive compensation, auditors must have an appropriate audit approach and access to the necessary

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information. Despite obstacles to obtaining this information, internal auditing needs to proceed in accordance with its charter. Its audit scope should focus on the board, management, and extended business relationships.

AUDITING COMPENSATION

As regulators and shareholders look more closely at executive compensation, internal auditors need to define their responsibilities in addressing rewards-management risks. Auditors must realize that the attitude toward risk-taking is largely determined by the organization's compensation practices and culture. Taking calculated gambles is one thing, but reckless risk-taking can spell ruin, especially when short-term rewards are personalized for gain, and longer-term risks can be socialized with impunity. A balanced, collaboratively designed oversight function can keep track of behaviors and performance metrics. For example, internal auditing can counsel human resources, the general counsel, the chief risk officer, the CEO, and the board about rewards-management risks.

Compensation committees bring transparency to ECB design and disclosures by subjecting themselves to an ECB audit. Indeed, when internal auditing is authorized to conduct these audits, the independent and objective scrutiny can ensure that the resulting compensation packages have credibility and integrity.

An ECB audit should focus on several key dimensions:

- Promoting greater awareness of "rewards management" strategies as a source of risk. The compensation committee must understand the organization's overall mission and objectives, as well as its risk appetite and tolerance as it evaluates ECB design.
- Cultivating an appropriate philosophy and structure for compensation committees to ensure that members are independent directors without any undisclosed conflicts of interest.
- Determining the process for selecting compensation consultants, evaluating the independence as well as the competence of consultants engaged.
- Evaluating the reasonableness of executive pay and perks. This delicate

audit area requires the highest degree of sensitivity, confidentiality, and collaboration with board members.

- Ensuring that all regulatory disclosure requirements (e.g., CDA) are complied with appropriately, adequately, and accurately.

Parveen Gupta suggested in a 2004 *Internal Auditor* article that ECB audits are uncharted territory for most internal auditors; remarkably, they continue to be. In many cases, internal auditing may not have the appropriate organizational positioning, stature, and competence to perform them. Nevertheless, auditors should welcome this expansion of their governance-related mandate. Auditors can move beyond the audit committee to become the compensation committee's eyes and ears, helping the organization practice effective rewards management.

TO COMMENT on this article, e-mail the authors at sridhar.ramamoorti@theiia.org.

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